Involuntary Conversions and the Question of Qualified Replacement Property

Section 1033 of the Internal Revenue Code of 1954 provides for the nonrecognition of gain when property is "compulsorily or involuntarily converted."[1] If an involuntary conversion results in a gain,[2] the gain need not be recognized if the proceeds of the conversion are invested in similar property[3] within a specified period.[4] The recognition of gain and the resulting tax are deferred due to the basis rule. This rule generally provides that the replacement property retains the adjusted basis of the converted property plus any amount spent in excess of the con-

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1. I.R.C. § 1033. The portions of § 1033 that will be dealt with in this article are reprinted below:

(a) General Rule.—If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted—

. . . .

(2) Conversion into money.—Into money or into property not similar or related in service or use to the converted property, the gain (if any) shall be recognized except to the extent hereinafter provided in this paragraph:

(A) Nonrecognition of gain.—If the taxpayer during the period specified in subparagraph (B), for the purpose of replacing the property so converted, purchases other property *similar or related in service or use* to the property so converted, or purchases stock in the acquisition of control of a corporation owning such other property, at the election of the taxpayer the gain shall be recognized only to the extent that the amount realized upon such conversion (regardless of whether such amount is received in one or more taxable years) exceeds the cost of such other property or such stock. . . .

. . . .

(f) Condemnation of real property held for productive use in trade or business or for investment.—

(1) Special Rule.—For purposes of subsection (a), if real property (not including stock in trade or other property held primarily for sale) held for productive use in trade or business or for investment is (as the result of its seizure, requisition, or condemnation, or threat or imminence thereof) compulsorily or involuntarily converted, property of a *like kind* to be held either for productive use in trade or business or for investment shall be treated as property similar or related in service or use to the property so converted. (emphasis added).

2. *See* I.R.C. § 1001.

3. I.R.C. § 1033(a)(2)(A) also makes nonrecognition available when property is converted directly into other similar property. This is rarely the case, however, and all of the litigation has focused on cases in which the conversion was into money.

4. I.R.C. § 1033(a)(2)(B) specifies a

period beginning with the date of the disposition of the converted property, or the earliest date of the threat or imminence of requisition or condemnation of the converted property, whichever is the earlier and ending—

(i) 2 years after the close of the first taxable year in which any part of the gain upon the conversion is realized. . . .

I.R.C. § 1033(f)(4) added by the Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1525, extends the period to 3 years "after the close of the first taxable year" in cases in which certain real property is condemned.

This long replacement period led one observer to note that, even though involuntary conversions are by their nature unforeseen, there are still ample tax planning opportunities. Gerver, *Voluntary Aspects of Involuntary Conversions*, 5 TAX ADVISOR 742 (1974). However, the taxpayer should not seek to have a fire destroy his property in order to maximize such opportunities. *Id.* at 751.

demnation award or insurance proceeds but less any amount of such proceeds not spent in purchasing new property.[5]

The general rule set forth in section 1033(a) requires that such conversions occur "as a result of [the property's] destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof."[6] Although this is in form a limitation on the applicability of the section, in practice it makes nonrecognition available in a wide range of cases. Replacement property qualifies under this section if it is "similar or related in service or use to the property so converted."[7] Traditionally this standard had been rather strictly applied. In 1958, however, Congress enacted the current section 1033(f)(1), which specifies a more lenient test for condemned *real* property held for "productive use in trade or business or for investment."[8] It allows "property of a like kind . . . [to] be treated as property similar or related in service or use to the property so converted." The two resulting tests are not exclusive, because real property that does not qualify as like kind may still be qualified under the service or use test.[9]

The Internal Revenue Service has developed a three test approach. In addition to the like kind test, the Service has divided the service or use test into two discrete tests. The basis of the division, which is set forth in Revenue Ruling 64-237,[10] is the distinction between two classes of owners: the owner-user and the owner-lessor. A "functional" test applies to owner-*users* of property. "Under this test, property [is] not considered similar or related in service or use to the converted property unless the physical characteristics and end uses of the converted and replacement properties [are] closely similar."[11] For an owner-*lessor* "a determination will be made as to whether the properties are of a similar service to the taxpayer, the nature of the business risks connected with the properties, and what such properties demand of the taxpayer in the way of management, services, and relations to his tenants."[12] The Service concedes that the effect of section 1033(f) is "to extend the nonrecognition-of-gains benefits of section 1033(a) of the Code to a taxpayer who acquires property of

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5. I.R.C. §§ 1033(b), 1011, 1016.

6. I.R.C. § 1033(a)(1).

7. *Id.*

8. Section 46(a) of the Technical Amendments Act of 1958, P.L. 85-866, 72 Stat. 1041. The paragraph designation was changed to (f) by the Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1525. The current designation is used throughout this article where practical.

9. *See* two-step analysis in Rev. Rul. 76-390, 1976-2 C.B. 243 and Rev. Rul. 76-391, 1976-2 C.B. 243.

10. 1964-2 C.B. 319.

11. *Id.* at 319-20.

12. *Id.* at 320.

a like kind to real property converted, but not necessarily similar or related in service or use to it."[13]

Involuntary conversions occur fairly often, particularly as a result of governmental acquisitions of private property for the development of public facilities. The long replacement period gives considerable tax-planning opportunities, but effective planning requires that the selection of replacement property be guided by readily ascertainable standards. The current state of the law, with the Code and the courts requiring two tests and the Service applying three, does not lend itself to such certainty. This Note will analyze these tests as they have been applied in three recent revenue rulings. It will suggest that a single service or use test be applied to both owner-users and owner-lessors. It will also consider the question presented in two of the revenue rulings —whether the construction of improvements on land owned by the taxpayer is a qualified replacement of converted land under section 1033 —and will suggest that such replacement be considered of like kind.

I. SIMILAR OR RELATED IN SERVICE OR USE

A. *Revenue Ruling 76-319*[14]

The corporate taxpayer in this revenue ruling was engaged in the operation of a bowling center, which consisted of bowling lanes, a lounge, and a bar. In 1974 the bowling center was destroyed by fire, and the taxpayer received insurance money in excess of its tax basis for the property, thereby realizing a taxable gain. The taxpayer used the proceeds to acquire a billiard center, which consisted of billiard tables, a lounge, and a bar. It then sought nonrecognition of the gain under section 1033(a).[15]

The Service denied nonrecognition, concluding that a billiard center is not similar or related in service or use to a bowling alley. Relying on the functional test, which Revenue Ruling 64-237 had reserved for owner-users of property,[16] the Service concluded: "The physical characteristics of the replacement property are not closely similar to those of the converted property since bowling alleys and bowling equipment are not closely similar to billiard tables and billiard equipment."[17]

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13. Rev. Rul. 67-255, 1967-2 C.B. 270, 271.

14. 1976-2 C.B. 242.

15. *Id.*

16. 1964-2 C.B. 319. This test is based on the physical characteristics and end uses of the converted and replacement properties.

17. Rev. Rul. 76-319, 1976-2 C.B. 242. The Service has again applied the functional test to owner-users in Rev. Rule 77-192, 1977-22 I.R.B. 12. In this ruling a land-based seafood processing plant was destroyed by fire and replaced by a seagoing plant. Nonrecognition was granted for replacement of destroyed equipment, but for the plant itself nonrecognition was denied. The Service reasoned that the taxpayer's ability to transport the new plant from one port to another was signifigantly dissimilar.

B. *Functional Test Owner-Users*

Neither the Code nor the Treasury Regulations offer much guidance in determining whether a particular piece of replacement property qualifies for nonrecognition.[18] In light of the case law, however, it is difficult to agree with the position taken by the Service in Revenue Ruling 76-319 regarding the dissimilarity between a bowling alley and a billiard center. The cases and rulings allow a range of replacement property that seems sufficiently broad to encompass these two forms of public amusement.

1. *Same Purpose or Use*

Both the cases and a revenue ruling indicate that similarity of the physical characteristics of the original and replacement property is not crucial for the latter to qualify as similar or related in service or use. A representative case is *Gaynor News Co.*,[19] in which the taxpayer acquired an improved lot that it leveled for the purpose of constructing a plant for its business. The property was condemned after all the improvements had been removed but before any construction was begun on the new building. The taxpayer used the condemnation award to purchase a corporation whose only asset was a lot improved by a building. The taxpayer tore most of the building down and used the remaining structure in the construction of its new plant. Under these circumstances the Tax Court thought it "unrealistic to set up a functional classification in terms of improved or unimproved property.[20] The old property, at the time it was taken over . . . was in one stage of the processing required to *achieve a planned objective*. . . . The *goal* in each instance was identical . . . the *function* and purpose of the old property, from the petitioner's perspective, was identical with that of the new."[21]

In Revenue Ruling 58-245[22] an improved lot used as a parking lot was replaced with another lot improved with a building. The taxpayer immediately demolished the building to convert the property into a parking lot. Finding that the new property had been made "suitable

18. Treas. Reg. § 1.1033(a)-2(c)(9) (1957) states:

There is no investment in property similar in character and devoted to a similar use if—

(i) The proceeds of unimproved real estate, taken upon condemnation proceedings, are invested in improved real estate.

(ii) The proceeds of conversion of real property are applied in reduction of indebtedness previously incurred in the purchase of a leasehold.

(iii) The owner of a requisitioned tug uses the proceeds to buy barges.

19. 22 T.C. 1172 (1954).

20. The court declined to apply Treas. Reg. 111, § 29.112(f)1 (1949), predecessor of Treas. Reg. § 1.1033(a)-2(c)(9)(i) (1957) to the facts of this case.

21. 22 T.C. at 1177, 1179 (emphasis added).

22. 1958-1 C.B. 274.

for the *use* for which the converted property was employed,"[23] the Service ruled that the replacement was qualified. "The test to be applied, in determining whether there is a [qualified] replacement, is the character of the service or use of the property."[24]

Just as the physical characteristics of the property at the time of conversion or replacement are not crucial, the ultimate physical characteristics of the property are not either. In *Cotton Concentration Co.*,[25] the taxpayer started out with two sheds for storing cotton. The west shed and one-half of the east shed burned down. With the insurance money the taxpayer built an enlarged east shed with improvements to prevent fires. The court rejected the Commissioner's interpretation of the section stating that "it would not be necessary for a taxpayer in order to receive the benefit of it, to reconstruct destroyed property in exactly the same physical condition as the original property."[26]

Nonrecognition also has been held not to depend on the proportionate allocation of insurance proceeds in the replacement property between buildings, machinery, and equipment.[27] The Service adopted this view in Revenue Ruling 67-254.[28] In that ruling a portion of the land on which the taxpayer's manufacturing plant stood was condemned. The condemned land had been used as a storage area and contained a garage that had housed the plant's delivery trucks. With the condemnation proceeds the taxpayer rearranged the plant on the remainder of the land to create a storage area and built a new garage for delivery trucks on a small plot of land he owned nearby. Although proceeds from the condemnation of the land were spent on construction and plant rearrangement, the Service ruled that in "restoring the plantsite so that it could be used in the same manner as it was used prior to the condemnation, he has acquired property similar or related in service or use to the property converted for purposes of section 1033(a)(3)(A) [now section 1033(a)(2)(A)] of the Code."[29]

Mode of ownership is another factor that has not been crucial to the qualification of replacement property. The Code treats the pur-

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23. *Id.* (emphasis added).

24. *Id. Cf.* S.H. Kress and Co., 40 T.C. 142 (1963) (property acquired to build store replaced by several stores or buildings to be used as stores held to be similar or related in service or use). For an earlier treatment of the subject see Henderson Overland Co., 4 B.T.A. 1088 (1926).

25. 4 B.T.A. 121 (1926).

26. *Id.* at 126. Nonrecognition was also granted in Columbus Die, Tool & Mach. Co., 1952 T.C.M. (P-H) ¶ 52,312 (condemned industrial plant on 9.1 acre tract replaced by 18 acre tract on which taxpayer planned to build expanded plant); Flaxlinum Insulating Co., 5 B.T.A. 676 (1926) (flax straw warehouse replaced by warehouse of different construction); Rev. Rul. 57-154, 1957-1 C.B. 262 (farm containing a residential property used for rental purposes).

27. Massillon-Cleveland-Akron Sign Co., 15 T.C. 79 (1950).

28. 1967-2 C.B. 269.

29. *Id.* at 270.

chase of eighty per cent of a corporation owning assets as a purchase of the assets themselves,[30] and the courts have held that leased property may be replaced by fully owned property. In *Davis Regulator Co.*[31] the proceeds from the condemnation of a building that the taxpayer had leased were used to construct a building devoted to the same business on land the taxpayer owned. The court held that the taxpayer's leasehold was an interest in real estate and that since the interest was sold and the money received was invested by the taxpayer in other similar real estate, no tax was due on the transaction. The Service has similarly ruled that the replacement of a converted farm with an interest as tenant in another farm, which is similar or related in service or use, is a qualified replacement.[32]

2. *Changes in Purpose or Use—Extent of Permissible Deviations*

Analysis of the variables of time, physical characteristics, and mode of ownership indicates that there is considerable leeway in determining what is qualified replacement property so long as the taxpayer puts the new property to the same use as the old. The difficulty arises when the taxpayer's use deviates from the purpose of the converted property. No clear formulation of the extent of deviation permissible is found in the cases other than the vague requirement that the new business be "related to" the old. The Service, in Revenue Ruling 76-319, evidentially found that the operation of a billiard center was not "related to" the operation of a bowling center. An examination of the cases construing this language may be helpful in evaluating the position of the Service.

The first case that interpreted the words of the statute was *Paul Haberland*.[33] During World War I the taxpayer's stock in a textile manufacturing business was seized by the alien property custodian and sold. When the taxpayer recovered the money from the custodian, he invested it in a business for making starch sizing for textiles. The court concluded that the replacement was qualified, noting that

> [I]f [section 1033(a)(2)(A)] limited the acquisition to "similar" property, we might have some difficulty in finding that petitioner's investment met the test. . . . But the word "similar" is followed immediately by the

30. I.R.C. § 1033(a)(2)(A), (E). *Cf.* Rev. Rul. 70-144, 1970-1 C.B. 170 (purchased by 50% partner of the remaining 50% owning assets similar to his converted property qualifies). *But see* I.R.C. § 1033(f)(2) (like kind rule does "not apply to the purchase of stock in the acquisition of control of a corporation described in subsection (a)(2)(A)."); Rev. Rul. 55-351, 1955-1 C.B. 343 (replacement of the property by acquisition of a partnership share is not a qualified replacement).

31. 36 B.T.A. 437 (1937). *But cf.*, Treas. Reg. § 1.1031(a)-1(c)(2) (leasehold is not like kind to a fee unless its term is 30 years or more). *See also*, The Davis Co., 6 B.T.A. 281.

32. Rev. Rul. 57-154, 1957-1 C.B. 262.

33. 25 B.T.A. 1370 (1932).

phrase "or related," which in our opinion, considerably broadens the scope of the statute and gives the taxpayer more latitude in making an investment. . . .[34]

In *M.J. Caldbeck Corp.*,[35] part of the taxpayer's property was used as a movie theater and part was rented to stores. The building was destroyed by fire, and the insurance proceeds were used to construct a building that the taxpayer leased to a large department store. The Board of Tax Appeals held that the insurance proceeds were a recognized gain because of the taxpayer's delay in making the replacement investment. The court commented, however, that had the taxpayer acted sooner the replacement would have qualified since both were business properties. Differences in construction did not matter to the court because "the statute does not require exact physical duplication."[36] In *Stevenson v. United States*[37] in an opinion devoid of analysis, nonrecognition was accorded a taxpayer, who replaced property devoted to truck farming and cattle raising with apricot, prune, and walnut orchards.

Although replacement property may be used in different, though related businesses, it appears necessary for the replacement property to perform an analogous function in the new business. In *United Development Co. v. United States*[38] the taxpayer replaced condemned property used for burial plots with a new cemetery administration building. In holding that the replacement did not qualify for nonrecognition the court rejected taxpayer's argument that the properties should be considered similar because they both contributed to the production of income through the operation of the cemetery.[39]

In *Lynchburg National Bank & Trust Co. v. Commissioner*,[40] the taxpayer had acquired a building that it was going to demolish so it could build an addition to its bank. Because of World War II it put off its plans and rented the building to a shoe store and a restaurant. The building was destroyed by fire, and the taxpayer applied the insurance proceeds to building the addition to the bank. The Fourth Circuit held that the replacement property was not similar or related in service or use to the old building. At first this holding seems to contradict those

34. *Id.* at 1379. *See* Diamond Milling Co., 10 T.C. 7 (1948) (flour mill replaced by flour and feed processing plant held to be similar or related in service or use).

35. 36 B.T.A. 452 (1937).

36. *Id. See* Washington Market Co., 25 B.T.A. 576 (1932) (plant, used for rented retail stalls, manufacturing ice, cold storage refrigeration, and lease storage and display space for wholesalers, replaced by property "used in operating the various phases of its business except that of providing stalls for retail market dealers" held to be similar or related in service or use).

37. 14 A.F.T.R.2d 5917 (N.D.Cal. 1964).

38. 212 F. Supp. 664 (E.D. Mo. 1962).

39. *Id.* In Arnold L. Santucci, 1973 T.C.M. (P-H) ¶ 73,178, the taxpayer replaced tangible personal property used in a car wash with a printing company. The court held that the taxpayer failed to show the replacement was similar or related in service or use.

40. 208 F.2d 757 (4th Cir. 1953).

cases that have held that a taxpayer's planned use governs the application of section 1033(a)(2)(A),[41] because here the taxpayer replaced a property that it originally intended to demolish in order to build a bank addition, with a bank addition. In *Lynchburg*, however, the plan had been temporarily abandoned due to the war and the taxpayer entered the rental business for the duration. This hiatus in effect resulted in the taxpayer acquiring new property that was of use in a completely different business.

Lynchburg, along with the other previously discussed cases, sets limits to the service or use test, at least as it is applied to an owner-user of property. In sum, it is the purpose or use of the property in the business of the taxpayer and not the physical characteristics of the property that controls the outcome. This lack of focus by the courts on the physical characteristics of the property has not been similarly applied in Revenue Ruling 76-319. Indeed, the Service based its decision on the physical dissimilarities between bowling and billiard equipment. Common business sense would appear to lead one to the conclusion that a billiard center, despite differences in the equipment, is quite similar to a bowling center. The two are essentially the same recreational business. Whatever deviation there is should not disqualify the taxpayer's choice of replacement property, especially in light of cases such as *Haberland*, in which the taxpayer was allowed to switch from textiles to chemicals because both were "related" to the same industry.

C. *Owner-Lessor—Liant Record Co. v. Commissioner*[42]

The replacement rules discussed above were developed in cases in which the taxpayer was the primary user of both the converted and the replacement properties. That is the situation in Revenue Ruling 76-319, in which the taxpayer was actively engaged in operating the destroyed bowling center and the subsequent billiard center.

The Service has said that a different standard applies to investors in rental property than is applied to owner-users.[43] The Code, however, speaks of one test, and a line of cases applying the Code to owner-lessors has supported the single test view. Prior to Revenue Ruling 64-237,[44] which introduced the two-test idea, the Service had said that there was only one test—the conservative "functional" test. The Tax Court consistently applied this test to all classes, holding that for an owner-lessor mere similarity in the investment character of the properties was not sufficient. The cases discussed below, which deviate from this position and apply more liberal standards, arose before, but were decided after the addition of the like kind test to the Code. These cases seem

41. *See* notes 19-24 *supra* and accompanying text.

42. 303 F.2d 326 (2d Cir. 1962).

43. Rev. Rul. 64-237, 1964-2 C.B. 319.

44. 1964-2 C.B. 319.

to be a reaction to the congressional disapproval of the courts' previously strict interpretation of the service or use test.[45] All but one[46] of the federal courts of appeals reversed the Tax Court or affirmed on grounds other than the functional test.

In an early case that raised the issue, the Board of Tax Appeals determined that the converted and replacement properties were similar in that they were both business properties and that the taxpayer derived rental income from both of them despite the fact that the lessees put the properties to different uses.[47] The Tax Court and the Third Circuit, however, went along with the Service's contrary view[48] in cases concerning owner-lessors of property.

Steuart Brothers, Inc. v. Commissioner[49] was the first of a series of cases that established the rule that considers the investment character of property to be an important one in the qualification of replacement property under section 1033(a)(2)(A). The taxpayer, engaged in the real estate business, owned a tract of land that it planned to rent as a grocery store and warehouse. After the property was condemned, the taxpayer bought two new properties, one rented to an auto dealer and the other to the owner of a fleet of taxicabs. The Fourth Circuit, reversing the Tax Court, compared the investments in real estate held by the taxpayer before and after the conversion and concluded that real estate held for investment is similar or related in service or use if the reinvestment is in real estate of the "same general class."[50] The court, however, did not elucidate on what it meant by this phrase.

In *McCaffrey v. Commissioner*[51] the taxpayer replaced a parking lot leased to a parking lot company with property consisting of a warehouse and parking area rented to a federal agency. The Third Circuit rejected the distinction between users and investors that had been set up by the Fourth Circuit in *Steuart*, preferring instead to apply the functional test to the end use of the property.

The Second Circuit, in *Liant Record Co. v. Commissioner*,[52] at-

45. In S. Rep. No. 1983, 85th Cong., 2d Sess. 72 (1958), the Senate Committee on Finance compared the law regarding involuntary conversions—at that time only the "similar or related in service or use" test was available—with the more lenient treatment for exchanges of "like kind" property (§1031). The committee concluded that it was "particularly unfortunate that present law requires a closer identity of the destroyed and converted property where the exchange is beyond the control of the taxpayer than that which is applied in the case of the voluntary exchange of business property." *Id.*

46. McCaffrey v. Commissioner, 275 F.2d 27, (3d Cir.), *cert. denied*, 363 U.S. 828 (1960).

47. M.J. Caldbeck Corp., 36 B.T.A. 452 (1937).

48. The position of the Service was stated in Rev. Rul. 56-347, 1956-2 C.B. 517, 518 where it was asserted that "[t]he purchase of income-producing property of one character to replace income-producing property of another character does not on that basis alone constitute a replacement." *See* G.C.M. 14693, C.B. XIV-1, 197 (1935).

49. 261 F.2d 580 (4th Cir. 1958).

50. *Id.* at 584. This approach was approved in S.E. Ponticos, Inc. v. Commissioner, 338 F.2d 477 (6th Cir. 1964).

51. 275 F.2d 27 (3d Cir.), *cert. denied*, 363 U.S. 828 (1960).

52. 303 F.2d 326 (2d Cir. 1962).

tempted to effect a compromise between the viewpoints of the *Steuart* court and the *McCaffrey* court. In *Liant Record*, the taxpayer replaced a condemned office building with an apartment building. In reversing the Tax Court's denial of nonrecognition, the Second Circuit required that "a single test . . . be applied to both users and investors, *i.e.*, a comparison of the services or uses of the original and replacement properties *to the taxpayer-owner*."[53] In making such a comparison the Second Circuit held that it was necessary to "compare, *inter alia*, the extent and type of the lessor's management activity, the amount and kind of services rendered by him to the tenants, and the nature of his business risks connected with the properties."[54]

The *Liant Record* test has been widely accepted in the other circuits. The appeal of the test is (1) that it seems to apply in all cases,[55] (2) that it establishes more specific criteria on which cases may be decided,[56] (3) that it seems to avoid the strictness of the physical end-use test without including extremely dissimilar investment properties,[57] and (4) that it seems to effectuate the congressional intent of inclusion in the rule rather than exclusion.[58]

Not all the circuits have completely adopted the *Liant Record* test. In *Filippini v. United States*,[59] the Ninth Circuit suggested an all-of-the-circumstances test for determining whether

> the taxpayer has achieved a sufficient continuity of investment to justify nonrecognition of the gain, or whether the differences in the relationship of the taxpayer to the two investments are such as to compel the conclusion that he has taken advantage of the condemnation to alter the nature of his investment for his own purposes.[60]

Yet, despite the different characterization of the test, the Ninth Circuit employed essentially the same criteria as did the Second Circuit in *Liant Record*. It merely expanded upon what the Second Circuit called "the nature of the business risks" by requiring consideration of facts "which would influence an investor in determining the attractiveness of the respective uses for his capital: the character and location of the particular properties; their potential and actual employment; [and] the state of the market of which each one is a part."[61]

In *Loco Realty Co. v. Commissioner*,[62] the Eighth Circuit approved

53. *Id.* at 329 (emphasis in original).

54. *Id.*

55. Liant Record, Inc. v. Commissioner, 303 F.2d 326, 329 (2d Cir. 1962).

56. Filippini v. United States, 318 F.2d 841, 845 (9th Cir. 1963).

57. Clifton Inv. Co. v. Commissioner, 312 F.2d 719 (6th Cir. 1963) (Miller, J. concurring); Loco Realty v. Commissioner, 306 F.2d 207, 215 (8th Cir. 1962).

58. Pohn v. Commissioner, 309 F.2d 427, 430 (7th Cir. 1962).

59. 318 F.2d 841 (9th Cir. 1963).

60. *Id.* at 844-45.

61. *Id.* at 845.

62. 306 F.2d 207 (8th Cir. 1962).

the result in *Liant Record.* The court reviewed the history of the prior case law and noted that the functional test was developed in the Tax Court when the taxpayers were the actual users. While approving *Liant Record,* the court ambiguously stated that it also liked the reasoning of *Steuart,* adding the proviso that something more than mere investment character is required. Whether "something more" refers to the *Liant Record* considerations is not clear.[63]

In 1964 the Service partially adopted the *Liant Record* test in Revenue Ruling 64-237,[64] but specifically limited it to owner-users. Thus, it established a dual standard for section 1033(a). The ruling states:

> [I]n considering whether replacement property acquired by an investor is similar in service or use to the converted property, attention will be directed primarily to the similarity in the relationship of the services or uses which the original and replacement properties have to the taxpayer. In applying this test, a determination will be made as to whether the properties are of a similar service to the taxpayer, the nature of the business risks connected with the properties, and what such properties demand of the taxpayer in the way of management, services and relations to his tenants.[65]

The Second Circuit in *Liant Record* explicitly rejected a bifurcated test, holding that "a single test [is] to be applied to both users and investors."[66] It relied on its understanding of congressional intent to allow nonrecognition to taxpayers who maintain continuity of interest and do not alter the nature of their investments. By enacting the similar or related in service or use test, Congress intended only one test. In a sense an owner-user is as much an investor as is an owner-lessor, and that investment should be evaluated in terms of costs and benefits. The Second Circuit in *Liant Record* spelled out three factors that should be considered: management activity; services rendered; and business risks.[67] The physical characteristics of the property itself are not considered.[68] Rather, the costs of the investment in time, money, and effort, and the benefits—depending upon rate of return and the risk involved—characterize investment property as investment

63. For other reasons for adopting the *Liant Record* test in whole or in part see Capital Motor Car Co. v. Commissioner, 314 F.2d 469 (6th Cir. 1963) (property leased at various times to auto agency, school, and paint shop replaced by property leased for construction of motel—court found similar relationship between taxpayer and property); Pohn v. Commissioner, 309 F.2d 427 (7th Cir. 1962) (replacement of property leased to gas station by property leased for construction of apartments—court required continuity of interest); Ziegler v. United States, 254 F. Supp. 202 (D. Colo. 1966) (buildings rented as car-lot office and repair shop replaced by properties rented as office and apartment—court found taxpayer used both properties for investment).

64. 1964-2 C.B. 319. *See* Harvey J. Johnson, 43 T.C. 736 (1965) in which the tax court makes a similar retreat.

65. Rev. Rul. 64-237, 1964-2 C.B. 319, 320.

66. Liant Record, Inc. v. Commissioner, 303 F.2d 326, 329 (2d Cir. 1962).

67. Similarly, *see* Filippini v. United States, 318 F.2d 841 (9th Cir. 1963).

68. *See* discussion on the functional test, section I.B.1. *supra* and accompanying text.

property. That an owner-user's investment may involve more time and effort and less cash than that of the owner-lessor should not remove the former from the investor class. One is as much entitled to the benefit of the tax law as the other; the difference in investment should affect only the weight given to the several elements of the test, not the selection of the test itself.

An application of the *Liant Record* test to the facts of Revenue Ruling 76-319 may still lead to a decision denying nonrecognition. This is ironic since a decision on the Service's terms—the functional test—should lead to the opposite result, as has been shown. The factors leading to a ruling of recognition under the *Liant Record* test, however, would be applied in a way much more satisfying than the tautological assertion that a billiard center is not similar to a bowling alley because they are different. The *Liant Record* test calls for a comparison of the demands that the investments make on the taxpayer for supervision and service.[69] In the circumstances of Revenue Ruling 76-319, the taxpayer's supervision and service activities are clearly similar. In both the bowling alley and the billiard center, the taxpayer provided family recreation facilities to the public, provided for the upkeep of the centers, and perhaps even dealt with the same equipment supplier. On this level the analysis is a common sense one, parallel to the discussion of the functional test above. On the second prong of the *Liant Record* test, which evaluates the nature of the business risk, the taxpayer may not fare so well.

To evaluate the nature of the risk, the criteria set forth in *Filippini* must be considered.[70] The factor that appears to be the most appropriate in this case is the state of the market. Bowling is a popular sport and is well established in many communities across the country. The same may not be true with billiards.[71] The new billiard center, at the time of acquisition, may have been much more speculative as an investment than a new bowling alley. If that were so, such a replacement would not represent a continuity of investment and would not be accorded nonrecognition treatment. If, on the other hand, billiard centers were an established business in the taxpayer's community, nonrecognition should result.

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69. *See* Filippini v. United States, 318 F.2d 841, 845 (9th Cir. 1963).

70. *Id.* at 845.

71. It is "Trouble (Oh we've got
Trouble) Right here in River
City! (Right here in River
City!) With a capital
T and that rhymes with
P and that stands for
Pool (That stands for
Pool).
M. WILLSON, THE MUSIC MAN 36 (1958).

II. LIKE KIND

The like kind test is a less stringent test for the qualification of replacement property for nonrecognition. The following discussion deals with two recent revenue rulings that refused nonrecognition when condemned land was replaced by improvements to another piece of land that the taxpayer owned. It is suggested that, although conceptually such a result is possible, it does not fit harmoniously with the liberal interpretation given the like kind test by the courts.

A. *Revenue Ruling 76-390*[72]

The taxpayer owned fifteen acres of land that he operated as a mobile home park. In 1975 the state condemned ten of the fifteen acres to put in a new highway. The condemnation award exceeded the taxpayer's tax basis for the land, thereby resulting in a realization of income. The taxpayer proposed to use the condemnation award to build a motel that he planned to operate on the remaining five acres. The Service ruled that this was not property similarly or related in service or use to the converted property and denied nonrecognition.[73]

The Service's attack was two-fold: it questioned whether the replacement property was like kind property[74] or, failing that, whether it was similar or related in service or use under section 1033(a)(2)(A). In applying the like kind test the Service relied on Revenue Ruling 67-255[75] in which the Service had ruled that an office building constructed on land already owned by the taxpayer did not constitute property that is of a like kind to the land converted. That ruling asserts that all "real estate" is not like kind and that "[l]and is not of the same nature or character as a building," regardless of the fact that they are both referred to as real estate.[76] In applying the service and use test to the facts of Revenue Ruling 76-390, the Service used the owner-user test, concluding that "the physical characteristics and end uses of a motel are not closely similar to those of a mobile home park."[77] Thus, nonrecognition was denied.

B. *Revenue Ruling 76-391*[78]

The taxpayer owned 50*x* acres of unimproved farm land that he leased to tenant farmers. The taxpayer sold the property under threat

72. 1976-2 C.B. 243.

73. *Id.*

74. By virtue of such determination the replacement would be considered similar or related in service or use. I.R.C. § 1033(f).

75. 1967-2 C.B. 270.

76. *Id.* at 271.

77. 1976-2 C.B. 243.

78. 1976-2 C.B. 243.

of condemnation to a municipality, and used the proceeds to construct a commercial building on other land he owned. The building was suitable for leasing as five separate units. The interiors of the units were left unfinished and the taxpayer was responsible for changes to accomodate new tenants. Although the taxpayer was also responsible for the surrounding parking lot and for maintenance during vacancies, the tenants assumed their own maintenance duties when they leased the property. The taxpayer was responsible for paying real property taxes and insurance but was to be reimbursed by his tenants. The tenants were responsible for paying personal property taxes.[79]

The Service again employed a two fold analysis, applying first the service or use test in its owner-lessor form, and then applying the like kind test. In applying the service or use test, the Service ruled that the difference in the taxpayer's maintenance duties prevented nonrecognition. In applying the like kind test, the Service reaffirmed its position in Revenue Ruling 76-390 that buildings and land are not like kind property. The Service stressed that "[a]lthough the term 'real estate' is often used to describe both land and improvements on the land, land and improvements are by nature not alike merely because one term is used to describe both."[80] Thus, nonrecognition was denied.

C. *The Like Kind Test*

The Service is correct in concluding that all real estate is not of a like kind. If all real estate were like kind, the words "like kind" in the statute would be superfluous, because section 1033(f) is limited only to involuntary conversions of real estate. Such a reading would allow all replacement property that is realty to qualify for nonrecognition. By its addition of the like kind test to the Code in 1958,[81] however, Congress indicated that it wanted to avoid the strict interpretation the courts had given to the service or use test. The Senate Finance Committee report on this amendment referred to section 1031 of the Code, which allowed nonrecognition of gain where "property held for productive use in trade or business . . . is exchanged for property of a *like kind*. . . ."[82] This provision was the subject of liberal interpretation, including the exchange of improved and unimproved real estate and the exchange of city property for a farm as like kind property.[83] Congress found it "particularly unfortunate that present law requires a closer identity of the destroyed and [replacement] property where the ex-

79. *Id.* at 244.

80. *Id.*

81. Section 46(a) of the Technical Amendments Act of 1958, P.L. 85-866, 72 Stat. 1641 added the current § 1033(f) to the Code, which applies the like kind standard to certain involuntary conversions of real property.

82. I.R.C. § 1031(a) (emphasis added).

83. *Compare* Treas. Reg. § 1.1031(a)-1(c) (1956) *with* Treas. Reg. § 1.1033(a)-2(c)(9) (1957).

change is beyond the control of the taxpayer than that which is applied in the case of the voluntary exchange of business property."[84]

Based on the idea that in both exchanges and involuntary conversions gain is not recognized when there is continuity of investment, the Senate Finance Committee saw "no reason why substantially similar rules should not be followed in determining what constitutes a continuity of investment in these two types of situations. . . ."[85] Why Congress chose to restrict the new provision to condemnations of real property is not known, though undoubtedly there must have been some feeling that it was more unfair to tax gain realized due to the action of the government than to tax gains realized due to natural disaster, theft, or arson.

Whatever the reason, section 1033 today grants like kind treatment to involuntary conversions involving "real property (not including stock in trade or other property held primarily for sale) held for productive use in trade or business or for investment."[86] The section 1033 regulations[87] refer to section 1031 and the regulations thereunder for a definition of like kind, thus effectuating Congress' intent that condemned real property be treated the same as voluntary exchanges. The most often quoted passage of the regulations on this point is section 1.1031(a)-1(B) which states that "[a]s used in Section 1031(A) the words 'like kind' have reference to the nature or character of the property and not to its grade or quality." Paragraph (c) of that regulation lists examples of like kind transactions: an exchange of city real estate for a ranch or farm; exchanges of a leasehold with thirty years or more to run for a fee; or exchanges of improved real estate for unimproved real estate.[88]

The courts have focused on several criteria for determining whether replacement property is of a like kind: duration of the interests; the extent of the interest; and the uses of the property. The Code, regulations, and cases have not considered the question presented in the two Revenue Rulings 76-390 and 76-391, which is whether the replacement of condemned land with improvements on other land owned by the taxpayer can qualify for nonrecognition. An analysis of the cases,[89] however, provides a rationale for resolving this issue.

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84. S. REP. No. 1983, 85th Cong., 2d Sess. 72 (1958).

85. *Id.*

86. I.R.C. § 1033(f)(3) added by the Tax Reform Act of 1976, P.L. No. 94-455, 90 Stat. 1525, allows a taxpayer to elect to treat outdoor advertising displays as real property. It is interesting to note that while Congress placed this kind of property in the like kind category it actually specified a slightly more liberal test. *Compare* § 1033(f)(3)(D) (outdoor advertising displays "considered property of a like kind . . . without regard to whether the taxpayer's interest in the replacement property is the same kind of interest the taxpayer held in the converted property.") *with* Treas. Reg. § 1.1031(a)-1(c)(2) (1956) (only a leasehold with 30 or more years to run is like a fee).

87. Treas. Reg. § 1.1033(g)-1 (1960).

88. Treas. Reg. § 1.1031(a)-1(c) (1956).

89. Because of Treas. Reg. § 1.1033(g)-1 (1960) and congressional intent to apply the § 1031

1. *Fee Interest in Land Replaced by an Interest of Lesser Duration*

Treasury regulation section 1.1031(a)-1(c)(2) provides for nonrecognition of gain when a fee interest in real estate is exchanged for a leasehold having thirty or more years to run. This regulation was upheld in *Century Electric Co. v. Commissioner*,[90] which allowed nonrecognition of gain from the sale and ninety-five year leaseback of a foundry. A more pertinent case, however, is *Standard Envelope Mfg. Co.*,[91] which addressed the question whether a fee interest exchanged for a leasehold of less than thirty years is a like kind exchange. In *Standard Envelope* the taxpayer sold its property at a loss with a leaseback for a year during which it expected to find a new headquarters location. In addition, the taxpayer took an option to extend the lease for twenty-four years, which it intended to exercise if it were unable to find a new place. In six months the taxpayer gave up its search and exercised the option. The Commissioner disallowed a deduction for the loss on the sale of the property, arguing that the loss should not be recognized because the taxpayer had received a leaseback—property of like kind. The tax court ruled that the loss was deductible, however, and that the transaction was not a like kind exchange because a lease must be for thirty years or more to be the equivalent of a fee.[92]

A secondary issue in *Commissioner v. P.G. Lake, Inc.*[93] concerned an exchange of a perpetual right in real estate for an interest of more limited duration. There the taxpayer made an assignment of an oil payment in return for a fee title to a ranch and business property. The Supreme Court held that such an exchange was not one of like kind properties.[94] In doing so, the Court expressed a rationale that may lie behind many of the duration cases. The Court said that "the exchange cannot satisfy [the "kind of class of property"][95] test where the effect under the tax laws is a transfer of future income from oil leases for real estate. . . . [T]hese oil payments were merely arrangements for delayed cash payment of the purchase price of the real estate, plus interest."[96]

The suggestion that such exchanges are not of like kind because they represented sales of the property for cash substitutes is not explicitly supported by the other cases.[97] This rationale, however, is sup-

like kind test to condemnations of real property no particular distinction has been made in the following discussion to distinguish § 1031 like kind from § 1033 like kind.

90. 192 F.2d 155 (8th Cir. 1951).

91. 15 T.C. 41 (1950).

92. *Id.* *See also* May Dep't Stores Co., 16 T.C. 547 (1951).

93. 356 U.S. 260, *rehearing denied* 356 U.S. 964 (1958). *P.G. Lake* joined five cases for decision of a capital gains issue. One, *Fleming*, also involved a claim of nonrecognition of gain resulting from exchange of property.

94. *Id.* at 268.

95. Treas. Reg. § 1.1031(a)-1(b) (1956).

96. 356 U.S. at 268.

97. Nevertheless, most of the other cases and revenue rulings involving the exchange of

ported in a slightly different context in Revenue Ruling 66-209,[98] which involved three parcels of land—*A*, *B*, and *C*—in a row. Taxpayer *Y* owned lots *A* and *C*. *X* agreed to purchase *B* and to convey it to *Y* in exchange for a thirty year lease on *A*, *B*, and *C*. Rental payments were $25x for the first year, $80x for the next five years and $90x for the remainder of the term. Despite the rule in regulation section 1.1031(a)-1(c)(2) allowing nonrecognition on an exchange of a fee for a leasehold, the Service ruled that this exchange did not qualify. In explaining the ruling the Service said that the fair market value of lot *B* was considered advance rental, as such, and includible in *Y*'s gross income. Thus, when an interest of lesser duration is exchanged for a fee, there is a suspicion that the fee is a cash substitute. And although the regulations treat a fee and a thirty-year-or-more lease as equivalents, when the circumstances are such that the taxpayer is receiving the fee in lieu of rental payment, the tax benefit is denied.

2. *Fee Interests, Easements, and Severable Mineral Rights*

While the duration of the interests is a determinative factor, the question whether the interests are classified as a full fee, an easement, or severable mineral rights does not seem to be crucial. In *Commissioner v. Crichton*[99] the taxpayer exchanged a three-twelfths fee interest in oil, gas, and other minerals for a one-half fee interest in a tract of improved city land.[100] The Fifth Circuit held the exchange was one of like kind, saying:

> In the light . . . of the rule the regulation lays down, of the examples given in the illustrations it puts forth, and of the construction which . . . the statute has been given . . . it will not do for [the Commissioner] to now marshal or parade the supposed dissimilarities in grade or quality, the unlikenesses, in attributes, appearance and capacities, between undivided real interests in a respectively small town hotel, and mineral properties.[101]

This conclusion has also been reached in a revenue ruling directly involving the like kind clause of section 1033.[102]

Another ruling concerning severable interests in land is Revenue

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perpetual rights in property for interests of lesser duration have reached the same result. *See, e.g.*, Kay Kimbell, 41 B.T.A. 940 (1940) (a working interest in an oil lease and an oil payment not like kind where oil payment was limited); Midfield Oil Co., 39 B.T.A. 1154 (1939); Rev. Rul. 55-749, 1955-2 C.B. 295 (fee title to realty and water rights—where water rights are real property—are like kind if the rights are perpetual). *But see* Fleming v. Campbell, 205 F.2d 549 (5th Cir. 1953) (exchange of undivided interest in oil and gas for a royalty of limited duration was held like kind).

98. 1966-2 C.B. 299.

99. 122 F.2d 181 (5th Cir. 1941).

100. Form of ownership has not been an issue in these cases. In *Crichton* the court treated the undivided interests of the tenants in common as if they were individual interests.

101. 122 F.2d at 182.

102. Rev. Rul. 72-117, 1972-1 C.B. 226 (unimproved land replaced by interest in overriding oil and gas royalties).

Ruling 72-549.[103] Under threat of condemnation the taxpayer granted an exclusive easement over his farm land for power lines. The taxpayer used the proceeds to purchase a lot with nominal rental improvements and a lot improved with an apartment building. The Service ruled that because "the easement and right-of-way that the taxpayer granted and the real estate properties that the taxpayer acquired are both continuing interests in real property and of the same nature and character . . . [they] qualify as 'like kind' property under section 1031 of the Code."[104]

3. *Different Uses or Physical Characteristics*

A related question is whether a difference in the use or physical characteristics of the lands affects the like kind determination. The regulations allow an exchange of unimproved for improved property,[105] and this position has been upheld by the courts. In *Biscayne Trust Co.*[106] the Board of Tax Appeals held that an exchange of an investment in real extate improved by a house with unimproved real estate "held for like purposes" was an exchange of properties of like kind.[107]

There may be other differences in the use of the properties without disqualifying the replacement. In Revenue Ruling 73-120[108] the corporate taxpayer's assets—water plant, pipelines, water mains, manholes—were condemned. The taxpayer purchased an apartment complex from its shareholders with the condemnation award. The Service ruled that because the corporation had paid an arm's-length purchase price and because "[b]oth are fee interests in real property and both either were or will be held for productive use in trade or business or for investment," the property was a replacement of like kind.[109]

4. *Land Replaced by Improvements to Land*

In Revenue Ruling 67-255[110] the Service reached a result that may seem inconsistent with other cases and rulings that grant nonrecognition despite great physical dissimilarities. The ruling involved two

103. 1972-2 C.B. 472.

104. *Id.* For other rulings involving severable interests, see Rev. Rul. 68-331, 1968-1 C.B. 352; Rev. Rul. 55-749, 1955-2 C.B. 295.

105. Treas. Reg. § 1.1031(a)-1(c) (1956).

106. 18 B.T.A. 1015 (1930).

107. *But see* Stanley H. Klarkowski, 1965 T.C.M. (P-H) ¶ 65,328, *aff'd without discussion of this point*, 385 F.2d 398 (7th Cir. 1967), in which taxpayer was denied nonrecognition for an exchange of improved rental property for unimproved farmland that was held for subdivision.

108. 1973-1 C.B. 369.

109. *Id.* *See* E.R. Braley, 14 B.T.A. 1153 (1929).

110. 1967-2 C.B. 270. In a recent case the Hawaii district court rejected Revenue Ruling 67-255. Proceeds of condemned agricultural land were used to make improvements to an industrial park also owned by the taxpayer. The court allowed nonrecognition because the taxpayer used the proceeds to reestablish his prior commitment of capital. Davis v. United States, 411 F. Supp. 964 (D. Hawaii 1976).

separate transactions. The first concerned the replacement of land held for investment purposes with the construction of an office building also held for investment purposes on land already owned by the taxpayer. The second concerned the investment of proceeds from an involuntary conversion of unimproved rural land in the installation of storm drains, water systems, roads and other improvements to rural land already owned by the taxpayer. The Service ruled that neither replacement qualified as like kind property, but the reason for the ruling is not clear except for the Service's observation that not all real property is like kind.

Revenue Ruling 67-255 is the basis for the conclusions reached on the like kind issue in both Revenue Ruling 76-390 and Revenue Ruling 76-391.[111] Neither improved on the Service's earlier analysis of the problem. A rationale that may serve to explain these rulings is that because improvements to land have a limited useful life they are analogous to leaseholds of less than thirty years and are therefore not of like kind with a fee interest in land. Such a rationale fits nicely with the cases involving mineral rights as well since they also seem to condition nonrecognition on the duration of the property interests. A complication arises when improvements are compared with fee interests in oil and gas rights. While such rights are contractually unlimited in time, common experience indicates that, like buildings and other improvements to land, mineral rights are exhausted in time. This fact has been recognized by Congress and is reflected in the section of the Code dealing with natural resource depletion deductions.[112]

The basic temporal similarity between depreciable improvements to land and depletable mineral rights seems to require similar treatment for the two classes of property. The question then remains whether improvements to land should be included in the class of property that is of like kind with mineral rights. Because the characterization of mineral rights as like kind with fee interests in real estate has received the imprimatur of the courts it seems unreasonable to treat improvements differently. Thus, the replacement properties in both Revenue Ruling 76-390 and Revenue Ruling 76-391 should have been found to be of a like kind with the condemned real estate.

III. CONCLUSION

Only two tests for determining whether property is a qualified replacement are mandated by the Code. The Service's attempt to expand the number to three ignores the conceptual framework upon which the section 1033 nonrecognition provision is built: involuntarily realized income should not be taxed if the taxpayer takes steps to

111. *See* notes 75 and 80 *supra* and accompanying text.

112. I.R.C. §§ 611-614.

replace the converted property in such a way as to represent a continuity in his investment. Because it is the investment that is to be preserved, the rule of qualification should be viewed in light of the investment character of the properties involved.

The similar or related in service or use test, though not construed as liberally as the like kind test, has a modicum of flexibility if applied to all involuntary conversions in accordance with the criteria set forth in *Liant Record* and subsequent cases: (1) the demands of the properties on the taxpayer, (a) the extent of the taxpayer's management activity, and (b) services rendered by him; and (2) the nature of business risks, (a) character and location of the particular properties, (b) their potential and actual employment, and (c) the state of the market. The application of a physical characteristics test only restricts the factors a court may consider in evaluating a given replacement and results in conclusory justifications for a ruling such as that in Revenue Ruling 76-319 that offers little on which a taxpayer can base his tax planning.

The regulations that discuss the like kind test define it as concerned with the nature an character of the property. While these words remain as vague as the words of the Code itself, a simple test has emerged from the cases that ties like kind to the duration of the interests involved. No rationale is given in the regulations for not allowing an exchange of a fee for a "short term" leasehold to qualify as a like kind transaction. A rationale that surfaces in the mineral rights cases, however, is that replacement property whose entire value is reduced to cash flow in a relatively short time is no more than a cash substitute. As such, it is not of a like kind to property that is held for productive use or for investment.

This Note has attempted to extract a rule of law from the cases that will allow identification of section 1033 replacement property in the most straightforward and predictable manner. The rules that emerged are at variance with the rules used by the Service in recent revenue rulings. The Service's position is strict and unflexible and may be directed more at protecting the revenue than at intellectual consistency.

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